

March 28, 2003

**Via Hand Delivery**

Kristi Izzo, Secretary  
State of New Jersey  
Board of Public Utilities  
Two Gateway Center  
Newark, New Jersey 07102

Re: **In the Matter of The Audits of The Competitive Services Offerings of New Jersey's Electric and Gas Utilities Pursuant to the Electric Discount and Energy Competition Act, N.J.S.A. 48:3-55, 48:3-56 and 48:3-58 BPU Docket Nos. AA02020094 and EA02020097**

Dear Secretary Izzo:

Please accept an original and ten copies of Public Service Electric and Gas Company's ("PSE&G" or "Company") comments on the findings and recommendations presented in the March 20, 2003 Final Draft Report of Liberty Consulting Group regarding the *Audit of the Competitive Service Offerings of Public Service Electric and Gas Company* ("Final Draft Report").

**I. PROCEDURAL HISTORY**

The New Jersey Board of Public Utilities ("Board") issued a Request for Proposal ("RFP") on March 20, 2002 pursuant to N.J.S.A. 48:3-55, 48:3-56 and 48:3-58 to secure the services of one or more independent consultants ("Contractor") to conduct audits of the competitive business segments of all New Jersey's electric and gas utilities. The purpose of the audits was to ensure that the utilities or their related competitive business segments did not enjoy an unfair competitive advantage over other non-affiliated purveyors of competitive services and to evaluate and review the allocation of costs between competitive and non-competitive services offered by the utilities or their related competitive business segments. The period encompassed by the audits was January 2001 through June 2002.

The scope of these audits was to review the utilities' competitive services offerings in relation to the Electric Discount and Energy Competition Act ("Act"), the Board's rules, regulations and orders related to competitive services. The Contractor would be requested to offer its expert opinion, based on appropriate methodology, as to whether there is strict separation and allocation of each utility's revenues, costs, assets, risks, and functions between the utility's electric and/or gas distribution operations and those of its related competitive

business segments. The contractor would also determine (1) whether there was cross subsidization between utility and non-utility segments within a public utility or holding company; (2) whether the separation of utility and non-utility organizations is reasonable based upon the Board's Affiliate Relations and fair competition standards; (3) the effect on ratepayers of the use of utility assets in the provision of non-safety related competitive services; (4) the effect on utility workers; (5) the effect of utility practices on the market for such services; and (6) compliance with the Act. As this was the second round of audits as required by EDECA, the Contractor would also be required to review the utilities' implementation of the recommendations accepted by the Board from the previous audit.

The Liberty Consulting Group submitted a proposal entitled "Audits of the Competitive Service Offerings of New Jersey's Electric and Gas Distribution Companies" dated May 16, 2002 ("RFP Response"). On June 26, 2002, the Board adopted Staff's recommendation to engage Liberty to conduct the audit of PSE&G and all New Jersey electric utilities. Liberty's RFP Response contained, *inter alia*, a statement of objectives and a statement of the substantive work to be accomplished, which statements may be summarized as follows:

... [O]bjectives of these audits [will be] ... to assure that:

- Neither the utilities nor their related competitive business segments enjoy an unfair competitive advantage over their competitors; and
- There is no form of cross-subsidization of competitive services by utility operations or affiliates with which they are associated.

... [S]ubstantive work that will be accomplished ... [includes]:

- Review of Major Corporate Structural and Operations Areas
- Cost Assignment and Allocation Methods and Results
- Adequacy of Separation of Business Segments
- Follow-Up from Prior Audits
- Quantification of Any Inappropriate Charges or Allocations

Liberty commenced field work regarding the PSE&G audit in July 2002. Field work was completed in January 2003. Liberty served PSE&G with approximately 300 data requests, conducted more than 15 working sessions with Company associates regarding audit areas, including organizational structure, cost allocation methodologies, corporate business planning, shared services (e.g. information technology, supply chain management), and communications and controls and, also, conducted a three-day transactional data testing working session to trace intercompany transactions from inception to final resolution, including billing and payment. These intercompany transactions included transactions between the Service Company and the operating companies and between the operating companies themselves.

## **II. INTRODUCTION**

PSE&G made a commitment with the adoption of EDECA and the Board's implementing regulations to conduct operations in accordance with relevant statutory and regulatory requirements. This commitment is embodied in the Standards of Integrity of Public Service Enterprise Group Incorporated, PSE&G's parent. The Standards of Integrity are

applicable to all subsidiaries and are communicated to all associates. PSE&G submits that the results of this audit demonstrate the sincerity of the Company's commitment in this regard.

PSE&G also made a commitment to the Board and Liberty at the outset of this audit to work collaboratively with Liberty to achieve audit objectives. PSE&G submits that it has demonstrated that commitment. In that regard, Liberty opines as follows:

"PSE&G provided substantially complete responses, or satisfactory support for the failure to provide such responses, to all of Liberty's audit data requests. With narrow exceptions, PSE&G demonstrated strong support for the timely provision of information to Liberty's audit team. The exceptions concerned areas where good faith concerns about the proper scope of the audit existed. Even in those cases, PSE&G sought to make arrangements for providing substitute information that it thought would serve Liberty's purposes and that PSE&G considered either to be in scope, or at least arguably so. Liberty believes that PSE&G has demonstrated sufficient willingness to make its books and records open for examination for compliance with the Standards. The Liberty audit team found their responsiveness to be commendable, despite a few areas of disagreement about proper audit scope."

### **III. STATUTORY AND REGULATORY OVERVIEW**

EDECA authorizes electric and gas utilities to provide certain competitive services offerings through a related competitive business segment of the utility and, also, establishes certain specific requirements regarding the utility's provision of such authorized competitive services. EDECA authorizes a related competitive business segment of the public utility holding company to provide any competitive service offerings without prior Board approval. EDECA provides, however, that an electric or gas utility is prohibited from using regulated rates to subsidize its competitive services or the competitive services offered by a related competitive business segment of the public utility holding company of which the electric or gas utility is an affiliate. Finally, EDECA directs the Board to adopt standards to:

"ensure that electric or gas utilities or their related competitive business segments do not enjoy an unfair competitive advantage over other non-affiliated purveyors of competitive services and in order to monitor the allocation of costs between competitive and non-competitive services offered by an electric or gas utility."

Standards adopted by the Board pursuant to EDECA, known as the Affiliate Relations, Fair Competition and Accounting Standards and Related Reporting Requirements, N.J.A.C. 14:4-5.1 et seq., can be generally segregated into three basic categories. The first category, which is set forth in Sections 3 through 5 of the regulations, governs the transactions between regulated utilities and affiliates which provide competitive services to retail customers in the State of New Jersey ("Affiliate Relations Standards"). The second category, which is set forth in Section 6 of the regulations, applies to the competitive services offerings by regulated utilities to retail customers in the State of New Jersey and governs the transactions, interactions and

relations between the regulated functions of the utility and the segments of the utility providing the retail competitive services in New Jersey (“Fair Competition Standards”). The last category covered by the standards is set forth in Sections 7 through 9 and covers regulatory oversight, dispute resolution and violations of the standards. This last category requires, inter alia, that each electric and gas utility file with the Board, and update annually, a compliance plan (“Compliance Plan”) which demonstrates that the utility has adequate procedures in place to ensure compliance with the Affiliate Relations, Fair Competition and Accounting Standards and Related Requirements (hereinafter collectively referred to as the “Board’s Implementing Regulations”).

#### **IV. PSE&G’S COMMENTS**

Liberty’s Final Draft Report is organized into seven sections. Section I contains introductory information, including a discussion of audit requirements, objectives and scope. It also includes a subsection which discusses PSE&G’s related competitive service business segments and articulates a definition of the term “retail competitive service”, an operative term in the Board’s Implementing Regulations.<sup>1</sup> Sections II through IV present Liberty’s conclusions regarding PSE&G’s compliance with the Affiliate Standards Regulations. Section V presents Liberty’s conclusions regarding PSE&G’s compliance with the Fair Competition Standards. Section VI presents Liberty’s conclusions regarding PSE&G’s implementation of the recommendations from the 2000 audit report. Section VII presents Liberty’s conclusions regarding impacts on PSE&G from affiliated operations. Liberty’s conclusions regarding the adequacy of the PSE&G Compliance Plan are discussed, as appropriate, in relevant sections of the Final Draft Report.

PSE&G believes that the results of Liberty’s audit, as will be discussed below, demonstrate that the Company’s efforts to assure compliance with the Board’s Implementing Regulations have been successful. To be sure, Liberty identifies findings, presents conclusions and makes recommendations regarding improvements to the Company’s efforts to comply with the Board’s Implementing Regulations. Except as will be discussed in more detail below, PSE&G accepts Liberty’s recommendations and will take the actions necessary to address same.

##### **A. Compliance Plan**

Liberty concludes that PSE&G’s 2002 Compliance Plan “is improved and is a useful document”. Liberty’s Final Draft Report presents six recommendations for enhancing procedures in the Compliance Plan to further assure associate compliance with the Board’s Implementing Regulations. PSE&G accepts Liberty’s recommendations and will incorporate them into the next annual update of PSE&G’s Compliance Plan to be filed in June 2003.

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<sup>1</sup> PSE&G disagrees with Liberty’s position on the issue of what constitutes a retail service, and, further, its position that the services provided by PSE&G’s Sunburst Solutions are retail services. PSE&G will discuss the basis for its disagreement below.

## **B. Fair Competition Standards**

Liberty observed that “PSE&G did ... undertake substantial and comprehensive compliance efforts” regarding the competitive appliance service offerings made through its utility RCBS, and, also, observed a PSE&G “commitment [regarding the utility’s RCBS] to follow the [Fair Competition] Standards.” In this regard, Liberty’s Final Draft Report presented the following conclusions with respect to PSE&G’s compliance with the Board’s Fair Competition Standards regarding the utility’s RCBS:

- PSE&G provides safety-related services at no cost to its customers and gives priority to such service calls.
- Technicians and support employees of the Appliance Service business unit track and report their time spent on each service as required by the Fair Competition Standards.
- PSE&G’s provision of competitive appliance repair services does not adversely affect PSE&G’s ability to provide safe, adequate, and proper electric and gas public utility services.
- PSE&G offers competitive Appliance Service products and services in a non-discriminatory manner to all customers.
- PSE&G maintains separate cost and other business data for Appliance Service and uses the information to report to the Board on a semi-annual basis as required by the Fair Competition Standards.

Liberty’s Final Draft Report presents two specific recommendations for implementation by PSE&G to assure full compliance with the Board’s Fair Competition Standards. PSE&G accepts these recommendations and will implement same in the ordinary course of business on a prospective basis. These recommendations may be summarized as follows:

- Include the cost of capital and installment-sale balances when calculating the costs of Appliance Service’s competitive offerings. The carrying costs will be based on the results of a cash-working capital analysis, which will include the weighted average of lag days in the collection of installment-sale revenues over the installment-sales collection period, as well as the weighted average of lag days in the payment of competitive Appliance Service’s operating expenses and profit.
- Require that Customer Service Specialists speaking with customers about non-safety related work inform customers as a matter of course that repair services may also be provided by third parties who can be found in the telephone directory and update the Company’s training program, as appropriate.

### C. Affiliate Relations Standards

At the outset, PSE&G would note that Liberty identifies a number of areas in which PSE&G's activities during the audit period were in compliance with the Board's Affiliate Relations Standards. These may be summarized as follows:

- There was no preferential treatment by PSE&G of PSEG ET or customers of PSEG ET.
- PSE&G did not offer any discount or waiver to PSEG ET.
- There was no tying of the provision of Utility products and services to the taking of goods and services from PSEG ET.
- PSE&G has sufficient controls in place to protect competitively sensitive information.
- PSE&G has adopted customer service processes that are adequate to protect customer proprietary information.
- PSE&G did not provide or release non-public information from any unaffiliated supplier to its affiliates.
- PSE&G kept adequate records and retained contract information sufficient to support all transactions tested during the audit.
- PSE&G's structure and operations comply with relevant provisions of the Board's Affiliate Relations Standards.
- There were no joint product or service offerings by PSE&G or any RCBS of its holding company during the audit period.
- There were no joint purchases associated with the merchant function that covered PSE&G during the audit period.
- Service Company organization, procedures, data collection, analysis, pricing and pricing systems should result in fully allocated costing and do not result in cross-subsidization.
- Service Company use of general allocators is appropriate and costs are directly charged whenever possible.
- The corporate planning process and associated controls for PSE&G and its affiliates are adequate to ensure that any affiliates do not benefit at the expense of PSE&G.
- PSE&G did not provide an affiliate with advertising space in any written customer communications.

- PSE&G has clear policies and procedures regarding the inclusion of utility employees in meeting to discuss technical and operational matters.
- There were adequate efforts to assure that each operating company paid for its own research and development activities and that PSE&G did not subsidize the R&D or advanced technology investments of other affiliates through common activities.
- PSE&G's human resources processes minimize the opportunity for movement of confidential information from PSE&G during employee transfers.

Liberty's Final Draft Report does present certain recommendations to enhance PSE&G's compliance with the Board's Affiliate Relations Standards. With limited exception,<sup>2</sup> PSE&G accepts Liberty's recommendations and will implement them in the ordinary course of business. In that regard, PSE&G will:

- affirmatively communicate to all involved departments and employees that PSEG ET is an RCBS.
- strengthen IT security policies and procedures to address the information exchange provisions.
- require periodic examination of the closeness of the relationship between total operating company procurement expenditures and procurement expenditures under master agreements and assure periodic updating of the allocation factors applied.<sup>3</sup>
- eliminate the double counting of the 9.25 percent overhead rate in the next planning cycle for use in 2004.
- make the required disclosure on all PSEG ET marketing materials, even if the materials are intended to be included in a multi-sheet packet.
- require Power to reimburse PSE&G in the amount of \$163,000 in the ordinary course of business for the time value of money lost to PSE&G during the processing of incorrect payments made by Tosco to PSEG ER&T during January through March of 2001.
- require that assets transferred from ET or other PSEG RCBSs to PSE&G be at the lower of fair market value or book value.<sup>4</sup>

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<sup>2</sup> PSE&G disagrees with Liberty's position on the issue of shared directors and officers. PSE&G will discuss the basis for its disagreement below.

<sup>3</sup> PSE&G does, however, take exception to the conclusion articulated by Liberty in the Final Draft Report that is related to this recommendation. PSE&G will discuss Liberty's conclusion and the basis for PSE&G's exception below.

<sup>4</sup> Liberty also recommends that PSEG ET be required to make a payment to PSE&G in the amount of \$90,440.25, plus accumulated interest, to resolve the issue identified in the Draft Audit Report with regard to the Teserra Project. PSEG ET will make the recommended payment to PSE&G in the ordinary course of business.

- base PSE&G charges to Holdings for the space leased by Holdings upon the higher of cost or market rate, rather than on the cost PSE&G pays, in the next planning cycle for application in 2004.
- change the exit-interview procedures to specifically mention the return of Company identification badges and key cards or other means of gaining entry to restricted areas, and include a requirement that managers verify that computer logins, IDs and passwords have been deleted.
- continue to monitor planned expenditures versus actual charges for Service Company products and services.

As indicated above, PSE&G takes exception to certain of Liberty's positions regarding the audit of PSE&G's compliance with the Board's Affiliate Relations Standards, as follows:

*1. SCM Cost Allocation*

Liberty reviewed the Services Corporation Supply Chain Management (SCM) organization to determine, among other things, whether the charges for this function were being imposed in accordance with the Board's Affiliate Relations Standards. Liberty concludes that the manner by which the Service Company imposes charges for this function fails to apportion costs as required by the BPU's Implementing Regulations and creates a potential for cross-subsidization.

Liberty correctly observed in making its conclusion that the SCM function negotiates and administers master purchasing agreements for products and services that multiple PSEG entities require. In addition to negotiating and administering these master agreements, the SCM organization is also responsible for managing the SCM process infrastructure across PSEG which Liberty's Final Draft Report describes as follows:

The SCM infrastructure process includes such functions as managing SCM strategic initiatives and enhancements, including strategic sourcing training and execution, commodity management, Electronic Data Interchange, vendor database, transportation and logistics management, incorporation of best practices, e-procurement implementation, diversity management, and establishment of uniform SCM practices and procedures.

Liberty also correctly observed that the SCM function costs are allocated based on each operating company's total incurred spending for purchases in a year (for the audit period, the year was 1999), whether or not such purchases were made under a master purchase agreement. The Company decided that total spending on materials and services was the best allocator since the SCM function, which includes both the administration of master purchase agreements and the management of SCM process infrastructure, is performed for the benefit of all PSEG units, including the Service Company, PSEG Power, and PSE&G.



PSE&G suggests that Liberty's conclusion that SCM's costs are not apportioned in accordance with the Affiliate Relations Standards is predicated on the basis that SCM's sole function was to negotiate and administer master purchase agreements and failed to properly consider the full panoply of the SCM function. PSE&G respectfully submits that the charges for the SCM function are appropriately apportioned as required by the Affiliate Relations Standards and, accordingly, do not create any potential for cross subsidization. PSE&G would respectfully request that Liberty's conclusion be revised to delete the characterization that SCM "fails to apportion costs as required by the Standards."

## 2. *Shared Directors and Officers*

Liberty concludes that the BPU Implementing Regulations prohibit an individual from serving as a Director or as an Officer for both the utility and a holding company RCBS. Liberty's conclusion in this regard is predicated on Section 14:4-5.5(q).

It is true that N.J.A.C. 14:4-5.5(q) contains a prohibition regarding common Directors and Officers. A companion regulatory provision, however, provides in pertinent part as follows:

An electric and/or gas public utility, its public utility holding company and related competitive business segments, or separate business segments of the public utility holding company created solely to perform corporate support services may share joint corporate oversight, governance, support systems and personnel. N.J.A.C. 14:5-5(i)

PSE&G submits that these regulatory provisions must be read together in making any determination with respect to the "sharing" of common Directors and Officers.

PSE&G takes exception to Liberty's regulatory interpretation on this issue. Liberty's Final Draft Report identifies a limited number of individuals who may serve as a Director and/or as an Officer of both the utility and an affiliate. These individuals are all employees of the Service Company and their specific responsibility is to provide strategic oversight, financial infrastructure advice and support, and governance support to the enterprise generally and the operating companies within the enterprise particularly.

PSE&G maintains that this is precisely what N.J.A.C. 14:5-5(i) contemplates. PSE&G further maintains that to argue that N.J.A.C. 14:5-5(q) prohibits such "sharing" would defeat an underlying purpose of N.J.A.C. 14:5-5(i). PSE&G submits, therefore, that the prohibition contained in N.J.A.C. 14:5-5(q) must be interpreted in the context of N.J.A.C. 14:5-5(i) and, further, not be construed as prohibiting "sharing" of a limited number of Service Company personnel for services as common directors or officers where such individual specific responsibilities include the provision of corporate oversight, financial infrastructure support and governance.

#### **D. Retail Competitive Services Under Board's Implementing Regulations**

Liberty concludes that PSE&G's provision of Sunburst meter reading services is a "retail" competitive service and, therefore, Sunburst is a utility RCBS for purposes of the Fair Competition Standards. Liberty's conclusions are based in substantial part on the rather unique definitions of "retail" and "wholesale" it employs in the Final Draft Report. Liberty's definitions of "retail" and "wholesale" are contrary to the plain meaning that these terms have in both everyday usage and in the business world. Moreover, Liberty's definitions of these terms would result in the application of the Board's affiliate standards in a manner that is inconsistent with the legislative intent of the Electric Discount and Energy Competition Act ("EDECA").

The Final Draft Report's discussion of the wholesale/retail issues is primarily in the "Introduction" section:

Liberty's use of the term retail is different from the one that PSE&G applies. Liberty applies the definition that is standard in the electric and gas utility industries, that only a sale for resale can be considered to be at wholesale. This means, for instance, that subcontracting to a prime contractor is a retail sale, as is providing parts to a manufacturer. In any case where the only significant value added by the purchaser is in making the purchased product or service available to a different market, the purchase can be considered wholesale. If, however, the purchaser makes a substantial transformation of the nature of the service or product, or if the purchaser bundles it with others in its offering to a different market, then the purchase should be considered retail. For example, selling windshield wipers to an auto parts store would be wholesale, while selling them to an auto manufacturer would be retail.

Liberty recognizes that there are other possible definitions, many of them in fact, but believes that the Standards would become almost trivial if a substantially more restrictive definition of retail were to be adopted. The Standards could, as is the case in some other states, merely have imposed code-of-conduct requirements on affiliates in the energy supply business; however, this is clearly not what has been done in New Jersey. Adopting a definition of "retail" that would exempt nearly all of the activities that affiliates have undertaken or are likely to undertake did not appear to be consistent with the broad thrust of the Standards. At least, Liberty did not feel comfortable adopting on its own initiative such a definition.

Liberty's definition of "wholesale" and its examples of retail goods or services<sup>5</sup> are contrary to the normal definitions of these terms in the commercial context and would result in an overly broad application of the Board's affiliate standards. Accordingly, PSE&G respectfully requests that the Board reject the Final Draft Report's definition of the terms "wholesale" and "retail" and, further, reject Liberty's conclusions and recommendations regarding Sunburst.

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<sup>5</sup> Notably, the Final Draft Report never provides a definition of "retail", even though the affiliate standards only apply to services provided "to retail customers in New Jersey." Apparently, Liberty views retail as everything that is "not wholesale."

### 1. *Legislative Intent and the Affiliate Standards*

The Final Draft Report's conclusions on the wholesale/retail issue are clearly contrary to the broad legislative objectives of EDECA. The purpose of EDECA was to partially deregulate the electric and gas utility industries and rely on competition – not to impose increased regulatory burdens on utilities and their affiliates. Yet, such an increased burden is precisely the result that Liberty's analysis of the scope of the standards would result in – the application of all of the affiliate standards to nearly all of a utility's affiliates. In any event, the Board's jurisdiction over utility rates under Title 48 is already sufficient to guard against cross-subsidization.

It is similarly clear that the Final Draft Report's recommendation that the definition of retail services be expanded is aimed at a specific end-result – broadening the scope of the affiliate standards to apply to all (or nearly all) of a utility's affiliates. The Final Draft Report states:

The Standards could, as is the case in some other states, merely have imposed code-of-conduct requirements on affiliates in the energy supply business; however, this is clearly not what has been done in New Jersey. Adopting a definition of “retail” that would exempt nearly all of the activities that affiliates have undertaken or are likely to undertake did not appear to be consistent with the broad thrust of the Standards. At least, Liberty did not feel comfortable adopting on its own initiative such a definition.

Liberty's statement that PSE&G's definition of retail is not “consistent with the broad thrust of the Standards” ignores both the legislative intent of EDECA, the language of the competitive services provisions of EDECA, and the Board's Affiliate Standards Regulations.

The 1999 enactment of EDECA resulted in significant alterations to the statutory framework for the BPU's regulation of New Jersey's electric and gas industry. In enacting EDECA, the New Jersey Legislature found that it was the policy of the State of New Jersey to: (i) lower the current high cost of energy, and improve the quality and choices of service, for all of this State's residential, business and institutional consumers...; (ii) place greater reliance on competitive markets, where such markets exist, to deliver energy services to consumers in greater variety...; and (iii) to maintain adequate regulatory oversight over competitive purveyors of retail power and natural gas supply and other energy services to assure that consumer protection safeguards ... are maintained. See Legislative Findings, N.J.S.A. 48:3-50 (emphasis added).

The statutory unbundling of the supply and distribution functions of the State's retail energy markets created a new framework for the BPU's authority over such unbundled services, including competitive services provided to retail customers in the State. Accordingly, the provisions of EDECA relating to the provision of competitive services are only applicable to retail services: “An electric public utility or a related competitive business segment of an electric public utility shall not offer any competitive service to retail customers within the state without the prior express written approval of the Board.” N.J.S.A. 48:3-55(a). This statutory mandate is limited solely to the provision of competitive services by electric public utilities to retail

customers in the State of New Jersey. No other statutory authority exists that would require regulated public utilities to obtain BPU approval for competitive services offered to non-retail customers or those geographically located outside of the State of New Jersey. With respect to public utility holding company affiliates (who may offer any competitive service without Board approval), the scope of EDECA is similarly limited to services provided to retail customers. N.J.S.A. 48:3-55(j).<sup>6</sup>

The Board's Affiliate Relations Standards comport with EDECA by applying only to the provision of goods or services to retail customers in New Jersey. N.J.A.C. 14:4-5.1 provides, in relevant part:

N.J.A.C. 14:4-5.3 through 5.5 set forth standards of conduct applicable to transactions between an electric public utility or gas public utility . . . and a related competitive business segment of the electric or gas public utility holding company providing or offering competitive services to retail customers in New Jersey . . . . (emphasis added).

N.J.A.C. 14:4-5.6 (the portion of the standards applicable to utilities and their competitive business segments) does not contain this similar language because EDECA squarely addresses the issue in N.J.S.A. 48:3-55(a). Therefore, it is clear that the scope of all of the Board's Affiliate Relations Standards (14:4-5.3 through –5.6) is properly limited to services provided to retail customers in New Jersey.

Notably, during the Board's promulgation of the initial interim Affiliate Relations Standards, commenters suggested that the scope be expanded to apply to the interaction between regulated utilities and all of their affiliates, regardless of their business or geographic location. Given EDECA's focus on the provision of services to retail customers in New Jersey, the Board did not adopt this suggestion. In properly limiting the scope of the Standards to affiliates providing services to retail customers in the State, the Board recognized that its already has sufficient authority under Title 48 to prevent improper cross-subsidization.

In sum, EDECA's legislative mandate on competitive services is clear and unambiguous – it does not extend to services other than those provided to retail customers in the State. Therefore, the Board's affiliate standards, which it adopted pursuant to N.J.S.A. 48:3-55 and 3-56, cannot lawfully expand beyond services to retail customers in New Jersey. Moreover, any interpretation of these sections of EDECA that would result in the application of the Affiliate Relations Standards over competitive services to non-retail customers would clearly be inappropriate. The Final Draft Report's recommendation to expand the scope of the standards through an inappropriately expansive view of what constitutes "retail services" is contrary to EDECA.

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<sup>6</sup> "A public utility holding company may offer any competitive service, including, but not limited to, electric generation service, telecommunications service, and cable television service, to retail customers of an electric public utility that is owned by the holding company, but only through a related competitive business segment of the holding company . . . ." N.J.S.A. 48:3-55(j), emphasis added.

## 2. *Definitions of “Retail” and “Wholesale”*

Faced with a legislative directive that limits the scope of the Affiliate Relations Standards to the provision of goods or services to retail customers, the Final Draft Report attempts to expand the concept of “retail” beyond all known and long-accepted definitions. PSE&G defines “retail” as the sale of commodities or goods in small quantities to ultimate consumers. The Final Draft Report does not offer an alternative definition of “retail”; instead, it uses a definition of wholesale, which it defines as “only a sale for resale.”

While PSE&G agrees that a “sale for resale” is indeed a wholesale transaction, Liberty’s application of its definition is far too restrictive, particularly when one attempts to apply it to the provision of services, as opposed to the sale of goods. Moreover, the Final Draft Report’s interpretation of what constitutes a “sale for resale” is also too restrictive. As a result, the Final Draft Report reaches clearly erroneous conclusions about what constitutes a retail sale.

For example, the statement that “Liberty applies the definition that is standard in the electric and gas utility industries, that only a sale for resale can be considered to be at wholesale” is directly at odds with federal rulings on the issue of electricity sales. The Federal Energy Regulatory Commission (“FERC”) has ruled that when electricity (which is a service) is sold to a generator to start a generating unit (known as “blackstart” service), it is a wholesale transaction, while the same generator’s purchase of electricity for light and heat at the generating station is retail. See *PJM Interconnection, L.L.C.*, 94 FERC ¶ 61,251, at pp. 61,889-91 (2001). Under the Final Draft Report’s definition of wholesale, Liberty would apparently find that blackstart service is retail, because the generator is “transforming” the blackstart electricity in the process of reselling it, not reselling the exact same service. Thus, it is evident that the Final Draft Report inappropriately uses an overly-narrow interpretation of “sale for resale.”

The Final Draft Report’s concept of retail and wholesale are also at odds with the accepted definitions of these terms. Webster’s Dictionary defines retail as “to sell in small quantities directly to the ultimate consumer; the sale of commodities or goods in small quantities to ultimate consumers.”<sup>7</sup> Clearly, Liberty’s characterization of the sale of windshield wipers to an automobile manufacturer as retail is incorrect: is not a “sale of commodities or goods in small quantities to ultimate consumers.” Black’s Law Dictionary contains a similar definition of retail: “A sale for final consumption in contrast to a sale for further sale or processing (i.e. wholesale). A sale to the ultimate consumer; Sales made in minimal quantities to ultimate consumer to meet personal needs, rather than for commercial or industrial users, citing *Witco Chemical Corp. v. U.S.*, 2 Cl. Ct. 504, 507 (1983).<sup>8</sup> Both the Webster’s and Black’s definitions clearly demonstrate that the Final Draft Report’s interpretation of retail sales is grossly overbroad. In fact, Black’s defines a “sale for further sale or processing” as wholesale. *Id.*, emphasis added. This directly refutes the Final Draft Report’s finding that if “the purchaser makes a substantial transformation of the nature of the service or product, or if the purchaser bundles it with others in its offering to a different market, then the purchase should be considered retail.” Thus, the provision of

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<sup>7</sup> *Webster’s Ninth New Collegiate Dictionary*, Merriman-Webster, Inc., Springfield, MA (1985).

<sup>8</sup> *Black’s Law Dictionary*, 6<sup>th</sup> Edition, West Publishing Co., St. Paul, MN (1990)

products or services that are “ingredients” in another product that is then sold to the ultimate consumer is clearly wholesale, even if the ingredient is processed prior to resale.

Webster’s defines wholesale as “the sale of commodities in quantity usually for resale.”<sup>9</sup> Black’s Law Dictionary defines wholesale as “[s]elling to retailers or jobbers rather than to consumers. A sale in large quantity to one who intends to resell.” Thus, it is also clear that the Final Draft Report’s concept of wholesale is too restrictive – neither authority restricts wholesale transactions to those where the good or service is not “transformed” or “bundle[d] with other offerings”, as Liberty contends.

PSE&G similarly disagrees with the Final Draft Report’s statement that “subcontracting to a prime contractor is a retail sale, as is providing parts to a manufacturer.” This blanket statement oversimplifies the issue and leads to clearly erroneous results. To determine whether a transaction is retail or wholesale, one must examine all its aspects: the nature of the goods or service; the nature of the customer; and what the customer does with the goods or service. Contrary to the Final Draft Report’s statement, the provisions of “parts to a manufacturer” clearly can be a wholesale transaction. For example, a manufacturer of car stereos sells in-dash CD players to Ford Motor Company, a manufacturer of cars. Ford installs the CD players in its cars, which it then sells to the ultimate users of the CD players (albeit through a network of retail dealers). Thus, the car stereo manufacturer is clearly engaged in a sale for resale, even though it is “providing parts to a manufacturer”: it sells CD players to Ford, who resells them, in substantially the same form, to its customers (after installing them in the cars), after adding the cost for the car stereo to the price of the vehicle. The wholesale nature of the stereo manufacturer’s transaction is not altered whether its customer (Ford) resells the product directly to consumers or does so through a retail dealer.

Thus, the Final Draft Report’s example of the sale of windshield wipers is illogical and incorrect.<sup>10</sup> Both sales described (to a parts store and to an automobile manufacturer) are clearly wholesale transactions. In both instances, the initial sale is wholesale because the purchaser is reselling the wipers to end-use customers.

In sum, the Final Draft Report attempts to oversimplify the term retail when it comes to services and thus reaches unsupported and illogical conclusions about what constitutes a retail service. The Final Draft Report’s statements and conclusions on this issue are contrary to EDECA’s legislative intent, the Board’s regulations, and the clear meaning of “retail” and “wholesale” in law and commerce. PSE&G respectfully requests that the Board reject the Final Draft Report’s statements and conclusions on the wholesale/retail issue and adopt PSE&G’s statements and recommendations as set forth here and in PSE&G’s letter brief of March 1, 2002 in Docket Numbers AA00040232 and EA00040235.

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<sup>9</sup> Webster’s, *id.*

<sup>10</sup> The Report states: “For example, selling windshield wipers to an auto parts store would be wholesale, while selling them to an auto manufacturer would be retail.”

### 3. *Sunburst*

PSE&G's Sunburst Customer Solutions group ("Sunburst") provides meter reading and payment processing services to municipalities and private water utilities. PSE&G disagrees with the Final Draft Report's conclusion that the services Sunburst provides are retail. Once again, the Final Draft Report's restrictive interpretation of "wholesale" is the root of the problem.

The Final Draft Report acknowledges that PSE&G provides the meter reading service for water utilities and municipalities, who then bill their customers for the service as part of a total bill for water service. This would appear to fit the Final Draft Report's definition of "sale for resale" in "essentially the same manner", because PSE&G provides the information to its customers (the municipalities), who then "resell" the result (i.e., the usage data) in the form of a bill to an end-use customer. The Final Draft Report's attempt to differentiate Sunburst by stating that the "entity does not resell the meter reads, but instead uses that information as an input to its provision of another service" does not withstand scrutiny. The water utility is indeed charging for, and therefore, reselling, Sunburst's service to its end-use customers, either as a cost component embedded in its water rates or through a separate customer service charge. Thus, even though PSE&G does not agree with the Final Draft Report's restrictive interpretation of "wholesale", Sunburst's services nonetheless fall within this definition.

Finally, the Final Draft Report's provides that "there is little distinction between what PSEG ET does and what Sunburst does." This statement has no basis in fact. PSEG ET clearly provides goods and services to end-use customers who do not resell them (e.g., HVAC services to office complexes) and are thus retail, even under the Final Draft Report's own definition. Conversely, Sunburst does not provide any services to end-use customers – it only provides services that are resold to the ultimate consumers (e.g., the municipal water company's customers). Thus, it is clear that the Final Draft Report overlooks the key distinction between the what PSEG ET does and what Sunburst does.

In sum, Sunburst's services are wholesale and, thus, it is not a utility RCBS subject to the Fair Competition Standards. Consequently, PSE&G respectfully requests that the Board reject the Final Draft Report's conclusion that Sunburst is a utility RCBS for purposes of the Standards, as well as all related conclusions and recommendations.

### **E. Impacts on the Utility from Affiliate Operations**

Liberty reviewed certain financial relationships between PSE&G, the utility, and its non-regulated affiliates and recommends that PSE&G be required to demonstrate on a periodic basis (i) its continuing ability to gain access to the capital markets, and (ii) that its investment in utility transmission and distribution plant and its expenditures for O&M continue to fully support service quality and reliability.

PSE&G does not dispute Liberty's recommendations that there should be periodic reporting to the Board related to credit quality and service reliability. However, PSE&G respectfully disagrees that there is a basis to imply that PSE&G's access to capital or financing

costs have been affected by being a member of the PSEG group, or that PSEG has reduced or would reduce utility capital or O&M below levels that are needed for PSE&G to maintain safe, adequate and proper service.

In that regard, there is no dispute that PSE&G had, during the audit period and continues to have today, ready and full access to the capital markets. Further, PSE&G's plant investment in transmission and distribution and operating and maintenance expenditures were, during the audit period and remain today, at levels sufficient to assure that PSE&G will continue to provide safe, adequate and proper service. There is also no dispute that PSE&G's strong posture has been maintained despite massive changes in the electric-utility business, including the restructuring of PSE&G by the Board, turmoil in the wholesale energy markets, including significant negative credit and liquidity events involving energy companies and non-utility operations that have not met expectations. This posture has been maintained despite the fact that PSE&G's utility rates do not reflect inflationary increases and more than \$1 billion investment in distribution utility plant over the past ten years and a cumulative rate reduction of \$1.4 billion over the past four years.

PSE&G's strong posture is evidenced by the fact that:

- PSE&G's credit rating for Mortgage Bonds and Commercial Paper has not changed;
- Customer service, as measured by SAIDI, CAIDI and SAIFI has remained stable; and
- Customer complaints have remained stable at a low level.

While it has maintained this strong posture, PSE&G and its affiliates clearly recognize the potential for negative effects on the utility from various matters, including corporate, regulatory, industry and market events. It is in the clear interest of Public Service Enterprise Group that PSE&G remain as a strong member of the corporate family, including access to the capital markets, cost of capital, and spending on utility capital and O&M to continue to provide safe adequate and proper service to customers in New Jersey. In that regard, PSEG recently has demonstrated that it is sensitive to the credit quality of PSE&G by making an equity infusion to PSE&G in the amount of \$170 million to help preserve financial ratios for PSE&G, which resulted in preserving an A- rating on PSE&G's Mortgage Bonds. PSE&G has always worked with the Board to provide it information and assurances of these credit and service levels and will continue to do so.

Liberty's recommendation, as set forth above, appears to be based on an analysis of three considerations. These considerations are S&P's downgrading of PSE&G's Corporate Credit Rating, changes in the electric utility industry, and the potential for impacts to PSE&G's service quality and reliability.

#### *1. S&P's Corporate Credit Rating*

Liberty's Final Draft Report indicates that the unregulated businesses within the PSEG family may have the potential to further affect PSE&G. In support of this conclusion,



Liberty points to the lowering of the corporate credit rating of PSE&G by Standard and Poor's on May 28, 2002.

At that time, the "Corporate Credit Rating" for PSE&G was downgraded by S&P. This was, however, the result of the application of S&P's "family rating" approach to PSEG and its subsidiaries. Under this approach, all corporate entities receive the same "Corporate Credit Rating" (i.e. BBB for all companies) based on the premise that management has the ability to move funds from one entity to another in times of financial distress, in order to prevent a credit default at the parent or one of its subsidiaries.

What Liberty fails to note is that S&P also issues a rating to the individual securities of each issuer in addition to issuing a "Corporate Credit Rating." Liberty also fails to note that lenders focus on specific issue ratings, not "Corporate Credit Ratings", in determining investment risk and the appropriate credit spread to apply. What is most important here is that S&P's specific ratings on all outstanding securities of all companies in PSEG have remained the same and there was no effect on the cost of capital and no impact on its ability to borrow funds by any PSEG company. Specifically, S&P reaffirmed the PSE&G senior secured debt rating (i.e. A-) and the commercial paper rating (i.e. A2) in the same release.

In establishing credit ratings, S&P assesses factors, including regulatory environment, management's experience and commitment, and financial criteria, with the existing regulatory environment being the most important factor. Financial criteria considered include interest coverages, debt to capital ratio, and funds from operations to total debt ratio. PSE&G operated outside of these financial criteria for the 2002 calendar period, however, S&P maintained the A- rating for the senior secured debt issued in September 2002 and January 2003. These securities were sold within the parameters specified by the BPU and were sold at spreads comparable to similarly rated utilities. As further evidence of the above, PSE&G's bond issuance spreads have not changed relative to its peers.

Credit reviews of PSEG and its subsidiaries are also issued by a number of other credit rating agencies, including Moody's and Fitch. In this regard, in October 2002, Moody's issued credit reviews for PSEG and its subsidiaries. At that time, the ratings of all of the PSEG companies were affirmed, but the rating outlooks for PSEG, PSEG Power, and PSEG Energy Holdings were changed to negative. This was the result of issues relating to unregulated activities. PSE&G's ratings were, however, affirmed at A3 and the outlook was cited as stable. Further, in July 2002, Fitch issued a ratings release affirming PSE&G's A- senior debt rating. This affirmation, however, was accompanied with a negative rating outlook. The release cited the reason for the negative outlook as lowered cash flow interest coverage resulting from a series of rate reductions since August 1999. The release further stated, "The outcome of the pending tariff filing will be critical to maintaining the existing ratings, which accounts for the Negative Rating Outlook". In this release, there was no mention regarding the possibility of unregulated activities of affiliates having a negative impact on PSE&G's credit rating. This strongly indicates that it is more likely that the potential impact to PSE&G's secured debt rating would be from not receiving reasonable rate relief in the pending electric rate case.

## 2. *Changes in the Electric Utility Industry*

Liberty notes that there have been massive changes in the electric utility industry since the Board put limitations in place in 1993 regarding PSE&G's affiliate operations. With respect to restructuring of the electric industry in New Jersey and of PSE&G, the Board weighed many factors and considered various options under the Electric Discount and Energy Competition Act of 1998. In ordering that PSE&G must transfer its generating stations to an affiliate that would agree to supply energy and capacity, at current customer rates, to PSE&G during the first three years of the four-year transition period, the Board assured a secure supply at fixed prices and eliminated deferrals for this period.

The Board's restructuring approach also kept PSE&G, as a distribution utility, a member of a New Jersey holding company. Although a separate distribution utility, in isolation, might arguably have a lower risk profile than a member of an energy holding company, a separate distribution utility likely would not remain independent, based on experience in New Jersey and elsewhere. Further, as a member of the Enterprise group, or some other corporate family, PSE&G would face similar risks. The wholesale market risk is the result of the federal deregulation of the wholesale markets and the Board's restructuring of the New Jersey energy industry, which impacts all distribution utilities. The restructuring risks, if any, related to the retention of PSEG Power within the Enterprise family are at best modest and are well balanced by PSE&G being a part of a \$25 billion diversified New Jersey energy company.

## 3. *Service Quality and Reliability*

Liberty notes that restriction to capital market access may make it difficult for a utility to meet capital and O&M needs. Liberty also notes, however, that it has not concluded that this point has been reached for PSE&G. PSE&G believes that it is appropriate that publicly available information concerning PSE&G's service quality and reliability should be considered to ensure that there is no negative implication associated with Liberty's comments.

In this regard, PSE&G would refer Liberty and the Board to the Stone & Webster report dated May 15, 2000 regarding extended outages in certain utility service territories in 1999. Stone & Webster was commissioned by the Board to comprehensively review New Jersey's electric utility system and Stone & Webster's findings and recommendations were documented in their May 2000 report. Board Staff, in recommending adoption of the Stone & Webster report, stated that "[PSE&G projected]...capital and O&M, operation and maintenance expenditures, do not appear to be an area of concern. They are in line with historical expenditures and we [do]...not see any other areas where reliability is a concern as it relates to O&M and capital expenditures." (Transcript of BPU meeting dated May 25, 2000 at TR. p. 7 l. 11-17.) Since issuance of this report, PSE&G provides the Board with a comprehensive annual report on maintenance and service reliability, broken down by operating division. The report is certified by an Officer of PSE&G, which certification provides that programs are being performed and are adequately funded by PSE&G and that PSE&G's business plans contain the programs and actions to achieve benchmark reliability levels. PSE&G has also offered to have

its Board of Directors make periodic certifications to the Board with regard to sufficient labor resources and service reliability.

4. *Conclusion*

PSE&G respectfully submits that the arguments Liberty advances in support of its recommendation regarding adequacy of steps to protect the utility from negative effects of affiliate operations are an incomplete presentation of all relevant facts. PSE&G believes that Liberty has overstated the potential effects of the non-regulated activities on PSE&G and has suggested a standard of proof that the Board itself has not used in similar situations and is not realistic or achievable in predicting future outcomes. Regardless, over the past year, PSE&G has offered to provide certain assurances to the Board, including a commitment to have the PSE&G Board of Directors annually certify to the Board that PSE&G has adequate capital funding, a reasonable dividend policy, a reasonable capital structure and investment grade credit quality to enable PSE&G to continue to provide safe, adequate and proper service. PSE&G believes that the information being provided to the Board and offered to address these issues are an adequate basis upon which the Board can determine whether financial or human resources have been, or are likely to be, reduced to a level that might affect credit or service quality.

V. **CONCLUSION**

PSE&G appreciates the opportunity to provide these comments regarding Liberty's Final Draft and requests that the Board appropriately consider same in connection with any final decision in the referenced matter.

Very truly yours,

C: Walter Szymanski  
Seema Singh, Esq., Acting Director  
John Antonuk, Liberty Consulting Group